Confluence Investment Management

# Weekly Geopolitical Report

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## Could the Coronavirus Pandemic Break Up the EU? – Part I

In times of crisis, the future is a luxury. Or, at least, thinking about the future can seem like a luxury, especially if you're reeling from the death of a loved one, the loss of a job, the devastation of a retirement portfolio, or just the boredom and isolation of a quarantine. Many people are overwhelmed with those challenges in the midst of the COVID-19 pandemic. And yet the pandemic is changing the future course of the world in ways that we'll all need to understand and respond to eventually. Those future changes extend to politics and geopolitical relations.

In this report, we explore the recent signs suggesting the COVID-19 pandemic could potentially lead to a break-up of the European Union (EU). In Part I, we examine the history of the EU, how it works, and the political and social fissures that undermine its stability. In Part II next week, we will look at the recent policy moves by various EU countries that could lead to disintegration if carried too far. We'll wrap up with a discussion of the possible economic consequences of a break-up and the ramifications for investors.

### Solving the German Problem

After the devastation of World War I and World War II, European leaders in the late 1940s and the 1950s were determined to avoid another war. They believed the key to avoiding conflict was to find a new way to manage the "German Problem" (see our *WGR* from April 3, 2017). Germany had to be tamed and pacified using better methods than in the Treaty of Versailles that ended World War I. That meant Germany had to be protected from both France and the Soviet Union. Germany's economy also had to be repaired in order for the rest of Europe to recover. Resolving the German Problem involved three key strategies:

- **Divide Germany.** The first strategy was to divide Germany to keep it from becoming too strong. After the war, the victorious Allies (the U.S., Britain, France, and the USSR) divided the country into four zones, with each of the Allies occupying one of them. Berlin, the capital, was also divided into four zones. The Potsdam Treaty of 1945, which created this division, was assumed to be temporary as it was thought that Germany would eventually become sovereign and unified again. However, it soon became apparent that Soviet leader Joseph Stalin would never allow democracy in the Soviet zone as the communists would lose power at the ballot box. A fearful France also opposed allowing Germany to unify. The country was therefore divided into West Germany (controlled by the U.S., Britain, and France) and East Germany (controlled by the USSR).
- **Create NATO.** The second strategy to defang Germany was to create the North Atlantic Treaty Organization (NATO) in 1949. By ensuring the defense of Europe against Soviet aggression and discouraging European rearmament, the U.S.-led military alliance aimed to

assure Germany it didn't need to develop its own strong, independent military. NATO members were required to spend at least 2% of their gross domestic product on defense, but the U.S. rarely tried to enforce the rule. Although below-target financial contributions by the Europeans required the U.S. to take up the slack, American policymakers were uncomfortable with European rearmament, fearing nationalism would rekindle militarism. The American policymakers were also unsure how consistently the Europeans would oppose communism. Thus, the U.S. effectively demilitarized Western Europe by taking over its defense.

- **Create the EU.** The third strategy to avert war was to foster intra-European economic ties that were so deep that the countries couldn't contemplate fighting each other.
    - The first major step was the 1951 creation of the European Coal and Steel Community, which tied together the industrial sectors of France, Belgium, Luxembourg, the Netherlands, Italy, and West Germany under a common supranational authority.
    - However, the founders of the EU had a much bigger goal: they wanted to bind the European countries together via the free movement of virtually all people, goods, services, and capital. With the Treaty of Rome in 1957, the organization was born as the European Economic Community (EEC). Its founding members were France, West Germany, Italy, Belgium, Luxembourg, and the Netherlands, but it expanded its membership over time.
    - The growing roster of countries also gradually signed treaties to form additional common policies, so that by the end of the Cold War, the organization was properly called the "European Communities."

**The EU: An Ever-Closer Union?**
The foundational treaties setting up the European Communities and the EU all refer to creating "an ever-closer union among the peoples of Europe." However, that political aspiration has generally taken a backseat to economic goals. The European Communities and the EU that succeeded them can best be seen as a customs union and free-trade zone under the direction of various supranational bodies headquartered mostly in Brussels, Belgium. The bureaucrats in Brussels have gradually extended their regulatory reach over significant parts of Europe's economy and social life. In theory, the bureaucrats are independent of national governments. In reality, national leaders have often used Brussels to force neo-liberal reforms and other unpopular initiatives on their citizens, only to pin the blame on the remote, technocratic, and increasingly unpopular "Eurocrats" on Rue de la Loi.

The modern EU was a direct response to the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991. Those events led to dizzying changes across Europe. Nations that had existed behind Churchill's Iron Curtain suddenly found themselves free of Soviet domination. Most importantly, West Germany found itself on the cusp of reunification with East Germany. As discussed in our *WGR* from April 10, 2017, the modern EU developed as follows:

***The Maastricht Treaty.*** Since the reunification of Germany would remove one of the key factors that had kept the peace in Europe for half a century, some European leaders found the prospect worrying. The French made it clear they would oppose reunification unless the new Germany could be bound closer to Europe. The answer to the issue was the Maastricht Treaty of 1992, which created the European Monetary Union (EMU), or the Eurozone. France insisted that Germany relinquish its fabled currency, the deutschmark, and replace it with a European currency. Given that a nation's currency is one of the most visible signs of sovereignty, the French believed that relinquishing the D-mark would bind Germany closer to Europe. Germany was reluctant to give up its currency, but its priority was to unify with its eastern compatriots. Therefore, Chancellor Kohl agreed to the EMU, with several key conditions:

- **Conservative Monetary Policy.** One key condition was that the new European Central Bank (ECB) would have policy aims similar to the Bundesbank, the German central bank. Its policy goals would be currency stability and inflation control. The ECB had an inflation target of 2%. Unlike the U.S. Federal Reserve or the Bank of Japan, it would have no mandate to ensure full employment or fast economic growth.
- **Conservative Fiscal Policy.** Germany's second condition was that the Eurozone would have firm fiscal rules. The German government was worried that the southern European states would run large fiscal deficits and borrow so much that German taxpayers would eventually have to bail them out. Thus, Germany insisted there would be no bailouts. The Eurozone nations also agreed to strict limits on their fiscal deficits, debt, and inflation. Although there were calls for a unified fiscal budget and a Eurobond backed by the full faith and credit of the Eurozone, Germany rejected such measures, fearing its savings would be absorbed by the bloc's free spenders.

***The Eurozone: 1999-2008.*** The EMU was set in motion on July 1, 1990, when capital controls were abolished and the principles of the Maastricht Treaty were accepted. By May 1998, 11 nations had agreed to adopt the single currency on January 1, 1999. Two years later, euro notes and coins were introduced. Greece joined the single currency in January 2001 and, by 2015, 19 nations were in the Eurozone (see Figure 1).

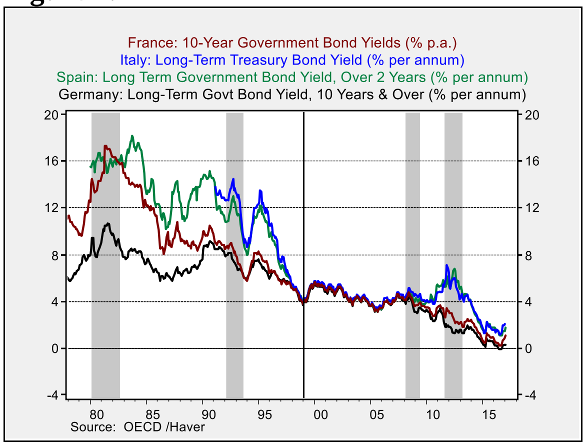
**Figure 1.**


*The Eurozone in 2015.*
*(*Source: *Continental Currency Exchange*.)

- Initially, the single currency worked rather well. Inflation and interest rates converged among the Eurozone's members. Countries on the southern tier who had suffered through high inflation and interest rates for years found themselves able to borrow at historically low rates.
- As shown in Figure 2, representative long-term interest rates on government bonds for France, Spain, Italy, and Germany converged at the beginning of the euro in 1999 and remained close until the Great Financial Crisis of 2008-2009. The financial markets believed there was no appreciable difference in

credit risk among nations in the Eurozone. The crisis ended that notion.

**Figure 2.**




***The Eurozone: 2008-Present.*** The Great Financial Crisis created conditions that led to the European Debt Crisis of 2010-11. Slowing economic growth, burgeoning bad debts, and widespread bank failures pushed many countries on the periphery of the Eurozone to the brink of default. This event revealed several difficult economic fissures for the EU that continue to simmer today:

- **Fractured Banking Systems.** Eurozone banks live in Europe but die in their country of origin. In other words, there was no mechanism in the EMU to deal with widespread bank failures. Banks in Europe regularly lent money across borders, but their home government was responsible for their liquidation if they failed. Although the national central banks continued to exist, within the Eurozone they could not act as lender of last resort because they did not have the ability to expand the money supply. That mandate rested with the ECB. Thus, bank failures could easily turn into bank runs.
- **Profligate Debt v. Rigid Currency.** The crisis also revealed stark intra-European disagreements over debt and currency adjustments. The Germans and most of the other northern nations believed the crisis was due to excessive borrowing, either in the public or private sectors. If this was the problem, austerity was the best response. The creditor nations would offer assistance, but bailouts were out of the question. On the other hand, the debtor nations believed the debt crisis occurred because the Eurozone prevented its members from depreciating their currencies to correct a balance-of-payments deficit. If this was the cause, the best response would be debt relief and stronger spending in the creditor nations. EU economic developments since the early 2000s tend to validate the debtor countries' argument.
    - From 2002 to 2005, Germany implemented a series of economic reforms designed to boost its international competitiveness. Most important, the "Hartz" labor market reforms sharply reduced labor costs, making German goods more competitive on world markets and boosting German exports.
    - The German reforms also served to boost the country's savings rate, thrusting its excess production onto the rest of the Eurozone. Since the Eurozone debtor countries couldn't depreciate their currencies, the only way they could have protected themselves from the German onslaught would have been to save more than the Germans, but that would have required their own excess saving and slower growth.

***The Ever-Fracturing Union.*** This survey of EU history provides the background for us to discuss the political, economic, and social fissures that could worsen because of the COVID-19 pandemic. In our view, the EU's fissures are not yet wide enough to guarantee a breakup, but they are growing enough to be a concern. Like a cracked foundation under a building, the disjointed political, economic, and social viewpoints among Europe's leaders and population render the organization susceptible to collapse in a storm or earthquake. The susceptibilities can be summarized as follows:

- **Germany's Colonization of Europe.** Although Brussels is often a target of derision for its bureaucratic control over the EU, it is actually Berlin that dominates Europe. From its influence over the Maastricht Treaty to its veto over sovereign bailouts during the debt crisis, Germany has thrown its political and economic weight around to the point where it has generated significant pushback. With its insistence that the response to the debt crisis favor creditor nations, Germany is especially resented by the debtor nations on Europe's southern periphery. France's pride and assertiveness usually form the main counterweight to Germany, but the southern periphery countries are also primed to push back against Berlin. After all, they are the most affected by German policies that generate excess saving and high domestic trade surpluses at home, along with big trade deficits, slower economic growth, and lower employment abroad. If the EU aimed to harness the benefits of the German economy and avoid German dominance, the attempt appears to have failed.

- **Regulatory Overreach.** As mentioned above, extensive EU regulation on Europe is also a threat to unity. Even though the EU's power structure includes a popularly elected parliament, the legislators are not an effective counterweight to the bureaucracy because they sit in Strasbourg, France, and are perceived as disconnected from the voters. EU economic policies are often seen as intrusive and irrational; they were a key reason why Britain exited the EU in January. EU political and social policies are also resented. For example, EU rules on judicial independence and freedom of speech have been ignored by Eastern European countries like Poland and Hungary.

- **The 2015 Migrant Crisis.** Frustratingly slow economic growth in the EU's southern tier of debtor nations and resentment over EU political and social rules among its Eastern European members were exacerbated by the migrant crisis of 2015. In that crisis, millions of mostly Middle Eastern refugees streamed into the EU. In Germany, Italy, and many other countries, the influx put new burdens on public budgets and increased crime and terrorism. Many EU citizens felt like their way of life was threatened by the newcomers. Much of the anger was directed toward German Chancellor Angela Merkel, who initially embraced the refugees.

- **Nationalism.** The frustrations listed above are merely the European manifestation of how globalism, technological change, and technocratic governance have sparked popular anger all across the globe. These frustrations have undermined political support for further integration and liberalization. Instead, they have spawned a backlash. Populist, nationalist political parties (predominantly right-wing) have garnered increased support in countries ranging from Germany and Italy to Austria and Spain. These parties advocate for returning sovereignty and power back down to Europe's historic nationalities as defined by their common ethnicity, language, and culture (see our [*WGR* from January 12, 2015]). Some have argued that their country should formally leave the EU. Even if that sentiment has waned after Britain's exit from the EU, we suspect it could regain traction in another crisis.

**Part II**

Part I of this series has shown that even though European strategies to avoid another world war have been successful for the last several decades, one of those strategies – the division of Germany – has ended, and another – the EU – is riven by fissures. The crumbling political, economic, and social foundation of the EU has rendered the whole edifice unstable. Germany and the rich, creditor nations of the north are at odds with the slow-growing debtor nations of the south. The politically liberal Western democracies are at odds with the more authoritarian eastern members. Many Europeans are angry at the intrusive bureaucrats in Brussels, while others feel overrun by foreigners and want their country back. With all these fissures, it should be no surprise that more than half of Europeans surveyed in mid-2019 said the EU would disintegrate within the next 20 years.

In Part II next week, we will take a close look at the recent policy moves by various EU countries that could lead to disintegration if they are carried too far. We'll wrap up with a discussion of the possible economic consequences of a break-up and the potential ramifications for investors.

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